DOW THEORY LETTERS INC.

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THE MARKET: Anyone who has elected (against my continued pleading) to ride his investments down in this bear market must now be exasperated (or apoplectic) as he follows all those advisory services which have been promising, week after agonizing week, that "the market is oversold" and that "the turn is just around the corner." It's been a long turn and a long corner! I have been warning that an oversold condition during a bull market reaction and an oversold condition during a primary bear market leg are two different animals. Already, that difference is becoming painfully obvious to today's stubborn investors.

The last Letter discussed the odd-lot public, and I noted that they have been buying entirely too much and too frequently as this market heads down. We are dealing with a public today which is neurotic, nervous, "whipped up" emotionally and perplexed intellectually. The public mind has been battered by talk of inflation, world crisis, monetary troubles, wars, race riots, higher taxes and a dozen other disquieting factors. But always, the public has comforted itself with the thought that somehow "Big Daddy" in Washington will make everything all right. Yet one can feel doubts and disillusionment creeping into the public mind. President Johnson's popularity rating has slipped to a new low, questions are being asked, the conduct of the war is being debated widely, and worst of all there is grave concern about the "creditability gap" between Washington and the nation (another way of saying that the Administration just isn't telling us the truth).

But one thing we can be sure of, the stock market is telling "the truth." It is saying that the times are changing, that troubles of all sorts lie ahead. The selling on Wall Street has already erased over 25% of the value of all stocks (as measured by the Dow), and still the liquidation goes on. The market is saying that the "pie-in-the-sky" dreams are over, that the theoreticians of the New Deal, the Fair Deal, the New Frontier and the Great Society are about to confront the fact that 2 and 2 equals 4. The vote-buyers and the funny-money adherents, the manipulators and the monetary "technicians" are about to receive their baptism of fire.

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The stock market has been placed under a "technical microscope" by almost every analyst in the nation. It has been pronounced "sold out", "exhausted on the downside" and "ready to rally" ever since last March. But each of the successive rallies have fizzled, and each subsequent bear leg has smashed the Averages into new low territory. What the analysts cannot seem to get through their heads is that this is a primary bear market, the first full-

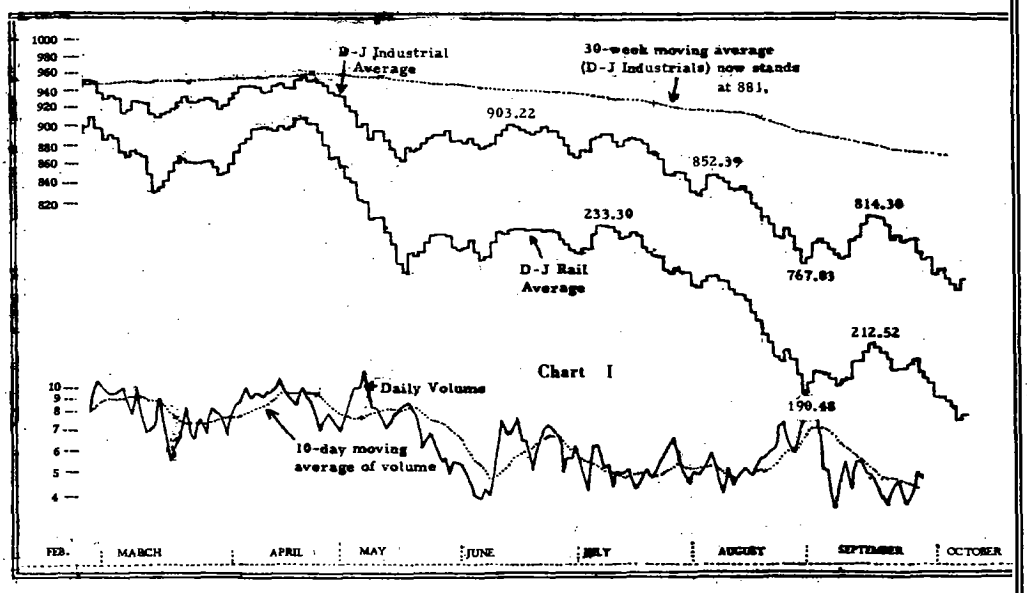
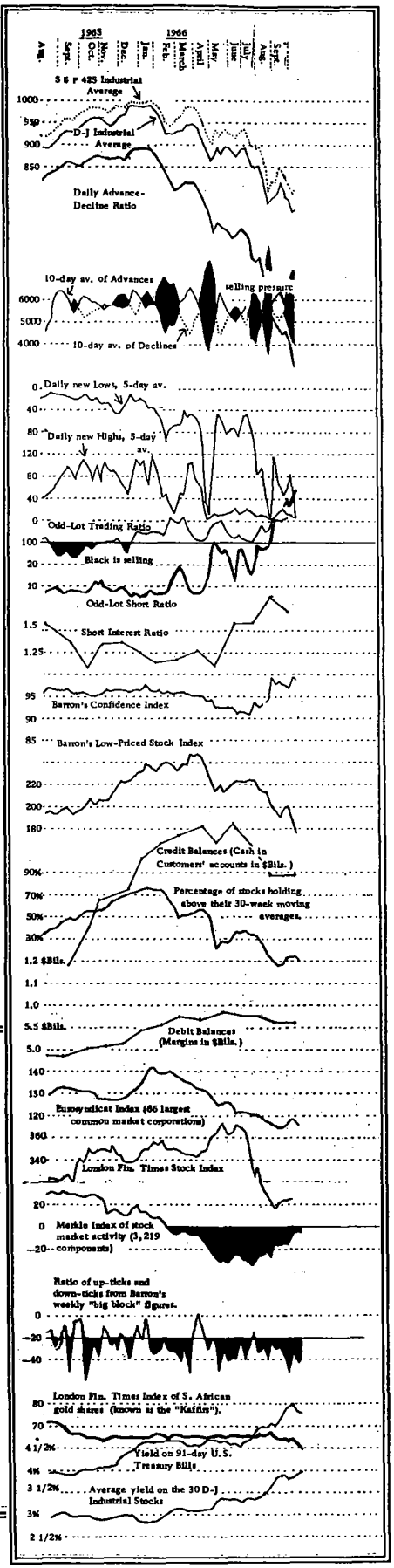


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Buyosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

fledged primary bear market within the memory of the majority of today's puzzled stockholders. And like all primary bear markets, this one is a law unto itself. It's going, where it's going, and it's going there in its own way. The current downward leg is going to run to exhaustion; it's going to keep liquidating until whatever bearish factors it sees are fully discounted in the price structure.

October 3 was a day which I took to be highly significant. On that day the Averages (Industrials and Rails) shattered the August 29 lows. The penetrations were simultaneous (both Averages broke the lows on the same day), and this type of simultaneous penetration has, in the past, constituted the most powerful type of Dow Theory signal. The original penetration which signalled this primary bear market (on May 5, 1966) also came as a simultaneous penetration, and I noted the power of that signal in the Letter of May 13 (Letter 323). Now we have received another simultaneous penetration of the lows by the Averages, and although no "signal" in the market is infallible, it does seem to me that the joint violations of October 3 should be treated with the greatest respect.

Aside from the joint penetration, a second phenomenon occurred on October 3. On that day the Industrial Average closed at 757.96. This was well under the halfway level of the entire 1962 (535.76) to 1966 (995.15) advance. That halfway level was 765.46. In Letter 335 I noted that because the August slide stopped at 767.03, the 50% Principle remained bullish. As of October 3 that situation has changed. By breaking the 765.46 level the 50% Principle has turned bearish in a major way for the first time in this bear market. The implication is that in time, as the primary bear market progresses, the market pendulum will decline and test the general area of the 1962 lows (535.76).

If there were any doubts remaining about the tremendous power of the current bear forces, they were removed on October 7 (last Friday) when Rails confirmed Industrials in a major way. The carriers confirmed by cracking their 1965 low of 187.29 (Industrials had violated their own 1965 low two months ago in August).

ON GOLD: In his latest (September) Monetary Report, Alden R. Wells notes that the net gold gain in world central banks last year was $255 million, lowest since World War II. Of the $1.4 billion in gold produced in 1965, $1 billion came from S. Africa.

I noted in Letter 235 that South Africa has a severe political problem, the fact that most of the world objects to its policy of separation of the races. The possibility of selected sanctions against South Africa is a constant hazard to that nation. But South Africa may be about to follow France's lead, it may be about to use gold as an instrument of political power. If South Africa were to withhold gold from the world markets (which it is now doing), it could force an international liquidity crisis. This would be South Africa's method of "taking the pressure off or else--."

States Wells, "The decline in net gain by central banks has arisen from increased gold usage in the arts and industry, and greatly increased hoarding. A continuation of the trend, without any withholding by South Africa could cause an end to any net gain this year, or next at the latest. Since South Africa has in fact begun withholding, a decline of $1 billion per year is visible. If central banks hold true to form, the U.S. would have to make up the deficit of $2.8 billion. Such a loss, following so many years of losses raises a strong doubt about the maintenance of the $35 price."

* * * *

Russia is in severe straits where gold in concerned. Various westerners used to estimate that $300 million of gold was produced by Russia annually. But that figure is probably greatly exaggerated, and the U.S. Bureau of Mines yearbook puts the figure at $196 million for 1964. Russian gold sales during 1952 to 1964 were almost $1 billion more than gold produced by Russia. By the end of 1965 it was estimated that Russian gold reserves were down to $2 billion.

Most Russian gold comes from northeastern Siberia. Transportation and production costs are high in Siberia and it is believed that Russian gold production costs are about $70 to $100 per ounce. Yet gold is worth only $35 on the world market. This gives some idea of the importance the Russians attach to the production of gold. In an effort to bring in more gold, the Russians are now building a new city in Central Asia, on top of what the Russians claim to be one of the world's largest gold deposits.

* * * *

From the Janeway Letter, September 27: "...Until the illiquidity crisis in Europe forced Britain into her recent emergency moves to dismantle her boom, the rule-of-thumb expectation for any sterling devaluation limited the writedown to 10%. This yardstick is now hopelessly outdated and unrealistic. If devaluation comes in Britain, it will spread instantaneously across Europe; and, if it comes, the odds are increasing that its bite will take something more like a 30% cut out of present values.

"The classic pattern of devaluation calls for a prelude of deflationary money squeeze and slump and the present crisis is certainly reproducing the classic pattern. We expect a sterling crisis by the year-end; and we see very little chance that it can be weathered without devaluation. Thanks to the deterioration on our side of the ocean, we now see very little chance of avoiding a wave of devaluation starting in Britain and spreading across Europe, with no exceptions."

ON VIETNAM from James Reston's New York Times column, September 25: "He (Johnson) will compromise. He will keep his word and get out. He will abide by the will of the Vietnamese, even if they agree to unite under a coalition or even a Communist government, but he will not run, and he probably will not fight a long stalemated war. In this next year, before the Presidential election, this conflict is either going to be settled or it is going to get much worse. For it is not only President Johnson but American opinion that will be pressing for even more military action if all the Communists and de Gaulle and the U.N. have to offer is a unilateral American withdrawal.

"This is not a hopeful picture, especially when viewed against the Communists' three points, but that is the present drift of the propaganda war, and it would be wrong to assume that these sharply conflicting themes are propaganda alone."

But what of the situation over the near-term, the next few months? Here a single question looms foremost in my mind: Will the market bottom out with no real change in the type of downside action we have been having for the last 8 months, or will there be a real panic-crash before the bottom? The fact is that there isn't a man alive who knows how this bear leg will terminate--or whether it will end today, next week or in December. But I want to warn my subscribers again (and they are probably getting tired of my warnings by now); I believe that something dramatic may be coming up, something that will tell all doubters, the die-hard bulls, the stubborn optimists, that "it's all over, and we are now swirling in the throes of a primary bear market of major proportions." Sooner or later in every primary bear market there comes a "cracking" sound, a "noise" that can be heard and almost felt. This is the sound of the price structure crunching under the onus of the full bear tide. That sound has not been heard yet. There are still too many arrogant people around who do not really believe that "the tide has turned." They will only be convinced by the final brutal ripping apart of the fabric of the market. In other words, I am of the opinion that a bone-jarring crash is a possibility over the weeks or months ahead.

When frightened people call to ask me, "Is it too late to sell?" I tell them that I haven't the slightest idea and only wish I knew. But personally, if I were in the market now, I would accept my profits or losses and run for the exits. It just is not sound policy to wait for a bear market rally to bail you out of your mistakes. When you're fighting the primary trend (as anyone who has ever shorted a bull market knows), the bail-out periods can be a long time in arriving. The fact is that the bullish stance has been a bitter one for investors ever since 1966 began. Up to now it cost them $200 billion in paper values, lost savings and evaporated assets. I will never know how many of my subscribers actually took my advice and sold out early in 1966. But subscriptions here have risen to the highest level in years, and I can only (hopefully) conclude that "somebody out there is listening."

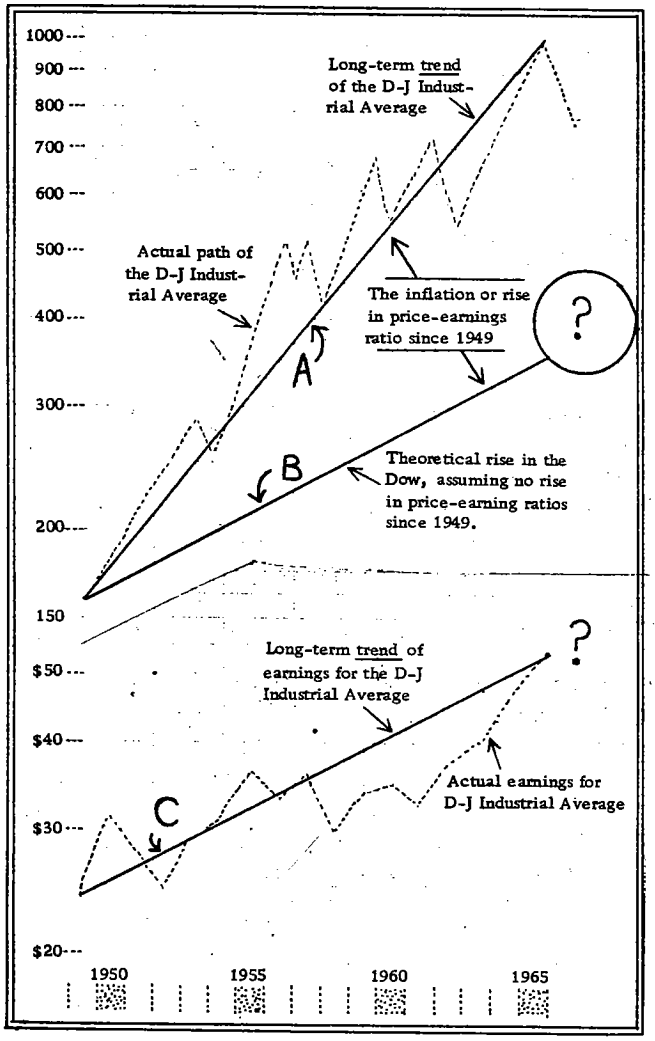
Yes, I am fully aware (as is every true Dow Theorist) that it does not make sense to increase one's bearishness as the market breaks to successively lower levels. Obviously, every 10 points down is 10 points nearer the next important bottom. And the fact is that sooner or later we are going to get the first full upward correction, a correction which will probably retrace 1/3 to 2/3 of all the ground lost since the February (995.15) peak in the Dow. When that correction arrives, all of us will breathe a sigh of relief. But it is (and has been) absurd to ride this primary bear market down with a full portfolio. Even the village moron knows enough to get off the tracks when he sees the train coming.

When the full upward correction does come, there will probably be a large number of subscribers who will want to step in and try for trading profits. I may even try to do a little upside scalping myself. Nevertheless, I am offering the opinion that I do not think the coming correction (when it arrives) will mark the end of the bear market. I believe it is going to be deceptive, and I believe the correction is going to be followed by another smash to new lows. In other words, even though I am out of the market now (and therefore reasonably unprejudiced), I am not kidding myself into thinking that "great investment opportunities" lie just around the corner. This has been a 17 year bull market, and it is going to take more than the February to October drop to correct it.

My subscribers are, on the whole, out of this bear market. We have had our money intact in U.S. Treasury bills and cash, and we have been part of that tiny minority which has avoided the terrible losses of the past year. Therefore, regardless of whether the market crashes in the next month or so or whether it bottoms out in October, I have felt entitled to talk about the full correction which must eventually arrive. I am not talking about that correction to "give hope" to those who have not sold (they're hopeless anyway). I have discussed that correction because how we handle it is part of our plan for survival (and perhaps even a few profits) in what is rapidly developing into one of the most vicious bear markets within living memory.

WHERE COULD WE GO? Two factors will serve to drive stocks down in a bear market: (1) A decline in actual corporate earnings, and (2) A decline in price/earnings ratios or in the amount investors are willing to pay for corporate earnings. The first factor is simple enough. A specific stock is worth more if it earns $10 per share than it is if it earns $5 per share. But the second factor, the change in P/E ratio is more subtle. This change is due to psychological and emotional factors. At a given time investors will pay $100 for a stock which earns $10. At another and happier time, investors may be willing to pay $200 for the same stocks earning the same $10. What has changed? At $200 for $10 of earnings, the investor feels a great deal more optimistic about the given stock's future than he did when he would only pay $100 for the same $10 of earnings.

The accompanying chart should be of interest. In 1949 the Dow Industrials earned $23.54. But investor sentiment was depressed in 1949 (even though that year marked the beginning of the great 1949-66 bull market). A measure of that depressed sentiment was the P/E ratio accorded the Dow stocks during 1949. The P/E ratio that year varied from 6.8 to a high of 8.5. In other words, with earnings of $23.54 (lower line on chart) in 1949, the Dow fluctuated within a price range of about 160 to 200 (upper line).



Trendline C represents the trend of the actual earnings on the Dow from 1949 to the present. The entire chart is drawn to semi-logarithmic scale so that it shows the rate of change. I have drawn trendline B parallel to trendline C. Thus trendline B represents "what would have happened to the Dow" if that Average had risen on the basis of increased earnings alone, with P/E ratios remaining at the 1949 level. The result is a bit startling. Here we see that if P/E ratios had held at the 1949 level, the increase in earnings from 1949 to 1966 would have resulted in a price of around 450 for the Dow today.

What then has caused the great rise in the Dow to the 1966 peak of 995.15? The "kicker," the reason for the massive rise is obvious if we study the chart. The greatest part of the rise from 1949 to date has resulted from the steady upward revision in P/E ratios. In other words, the fact of the case is that if the Dow were now to sell at the 1949 P/E ratio of roughly 7.6, then the Dow (at current earnings of $59) would be selling in the mid-400's!

Now, what happens during a major bear market? During a bear market both actual earnings and P/E earnings tend to decline over a long period of time. Earnings and investor sentiment become depressed. I have been asked repeatedly, "Russell, where do you think this bear market could go on the downside?" My guess is this: I do not know if this bear market will be so bad as to knock the earnings on the Dow back to their 1949 level of $23.54. I hope it does not get that bad. But I do think there is a chance that earnings will go down substantially on the Dow. Secondly, I do not know whether psychology is going to turn so black as to drive P/E ratios back to their 1949 level of around 6.8 to 8.5. But P/E ratios could certainly go down with earnings. If I had to guess, I would guess that before this bear market is over the Dow will move down to within striking distance of trendline B. I have drawn a "theoretical circle" within which I believe the Dow could ultimately fall. That circle encompasses an area of around 350 to 475 on the Dow. Sound impossible? It doesn't if you know about bear markets, and if you study the implications inherent in the accompanying chart.

BEAR MARKET MONTAGE: I have pasted together a few news clips which I thought were interesting and indicative of the early phase of the bear market. No real downturn in the economy is fully apparent or obvious as yet. But a number of disconcerting headlines are managing to creep into such publications as the Wall Street Journal and Ward's Automotive Reports. They indicate to me that the bloom is off the economic rose. The rose hasn't faded completely as yet; neither is it as fresh as it was six months or a year ago.

THE WALL STREET JOURNAL,

Margin Calls on Rise At Securities Lenders As Stock Prices Drop

But Most Banks, Brokers Expect No Sizable Boost, Note Loans Have Been Watched Carefully

By a WALL STREET JOURNAL Staff Reporter

NEW YORK—Several banks and brokers said they were increasing calls to borrowers of securities loans for more cash or collateral in wake of yesterday's share drop in stock prices.

Most securities lenders indicated, however, they didn't expect a sizable increase since most institutions have been keeping a watchful eye on securities loans to make sure adequate equity backs each account. In many instances this monitoring is done by computers.

Merrill Lynch, Pierce, Fenner & Smith, Inc., the nation's largest brokerage house, said there will be an increase in calls but it was "too early to gauge the extent." A spokesman noted accounts had been checked last Friday and that calls had already shown a nominal rise, in light of the continued lower drifting of the stock market.

Another large brokerage house said it expected to make about 300 calls on securities loans. He called that figure "about normal for this kind of a stock-price drop."

Factory Orders And Shipments Fell in August

Faster Inventory Building Was Only Inflation Sign, But Importance Is Doubted

Increase in Backlogs Slowed

By a WALL STREET JOURNAL Staff Reporter

WASHINGTON—New factory orders in August fell about 2% from the month before and shipments slipped slightly, the Commerce Department reported, while the long rise in the backlog of orders slowed significantly.

The only aspect of factory activity in August that added— noted, was a mo ventories. Some o ing" against poss—

OCT. 10, 1966 No. 41

Low Rate of Gain in September Production, Orders Causes Concern, Buying Agents Say

By a WALL STREET JOURNAL Staff Reporter

NEW YORK — New-order and production rates gained in September according to a monthly survey of purchasing executives. But the improvement was below last year's seasonal upturn, causing "concern" over the outlook for the next 12 months.

The National Association of Purchasing Agents said the survey showed 33% of members responding had a higher level of orders in September than in the previous month, up from the 31% that cited improvement in orders in August. However, this was sharply below 43% reporting new-order gains in September 1965. Business activity in the fall normally

percentage since February. There were 57% saying that the higher cost of money is affecting their inventory policy.

As to capital spending plans for the rest of the year, 31% said tight money would have a slight effect and 29% expected a serious impact. Members also cited continuing tightness in labor and material markets.

The September employment picture is relatively stable so far, according to the association. It said 12% of members had fewer employes last month, against 6% noting a drop in August. But 27% of members reported higher payrolls in September.

Price trends moderated in September. The impact of steel price boosts reflected sharply

WARD'S AUTOMOTIVE REPORT

Dealer Inventory Reaches 1,214,200

Franchised dealers ended September with a total new car inventory already at a level not reached last year until Dec. 31.

Accordingly, for dealers and factories alike coming months shape up as a period of more intense competition. With dealers in many lines more amply stocked vs. fourth quarter last year, sales via inventory pressure in some lines may be more in vogue, the extent geared to how closely the auto makers tie production to sales trends. GM dealers for several years have carried unusually low stocks in days' supply.

Totaling 1,214,200 of the '66 and '67 models on Sept. 30, the dealer inventory contrasted with 1,064,400 units at the same point last year. Earlier new model production start-ups, principally at GM, explain the increase.

The industry's intro stocks last year did not reach that level until Dec. 31, when they totaled 1,256,300 units, including units in dealers' hands and in transit.

Actually, further increases in the dealer inventory can be expected. But a 1,300,000 to 1,400,000 stockpile by Dec. 31 could take some of the steam out of production in the early months of 1967, because production would

STOCKS: A few groups are now favorable standouts on the basis of relative strength performances. These include Containers (Amer. Can), Drugs (Bristol-Myers, Merk, Schering) and Rubbers (Firestone, Goodrich, U.S. Rubber). These stocks in parentheses together with Proctor and Gamble in the Soap group are the ones I will be watching for possible trading operations during the full correction which lies somewhere ahead.

Of interest is the daily chart of General Motors. This pivotal stock hit a low during August, and its relative strength line is now trending up. Should GM avoid a new low for the year during the period ahead, and should GM's relative strength line continue to rise, I would consider this a plus sign for the entire market. While GM's action is obviously not an exact timing device, it is, of late, a plus, and I want to call plus signs (as well as minus signs) to the attention of subscribers.

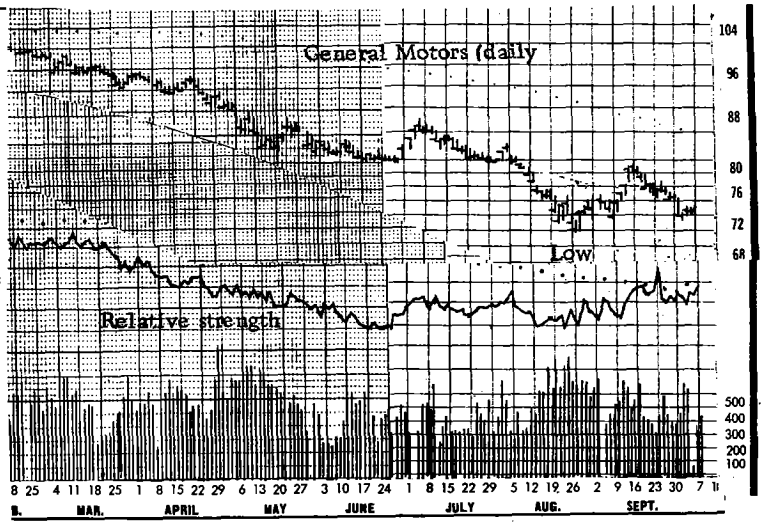


Chart of GM courtesy of Traders Research, 1431 Pearl St., Alton, Ill. 62003.